

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: AR&T Committee Analyst: Kimberly Pantoja Bill Number: AB 1635
Related Bills: None Telephone: 845-4786 Introduced Date: 03/03/99
Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: Filing Status of Individuals

SUMMARY

This Franchise Tax Board (FTB) sponsored bill would:

1. allow the FTB to revise the California return to reflect the proper filing status (making the filing status different from the status on the federal return) when the filing status used on the return is determined to be incorrect;
2. allow taxpayers who are not required to file a federal return to select any filing status for the California return that could have been claimed on the federal return had one been required; and
3. allow taxpayers who file a joint return for federal purposes and are allowed to file either married filing separate returns or a joint return for California purposes to change their California filing status after the due date for filing the return has passed.

EFFECTIVE DATE

This bill would apply to taxable years beginning on or after January 1, 2000.

SPECIFIC FINDINGS

Current federal law provides five filing statuses: (1) single, (2) married filing jointly, (3) married filing separately, (4) head of household, and (5) qualifying widow(er) with dependent child.

Generally, the filing status depends on whether the taxpayer is considered unmarried or married. Taxpayers who are unmarried or separated from their spouse by a divorce or separate maintenance decree and do not qualify for another filing status must file using the "**single**" filing status.

Married taxpayers who agree with their spouse to file a joint return may choose the "**married filing jointly**" filing status. If the taxpayer's spouse died during the year, the taxpayer is considered married for the whole year and may choose the married filing jointly filing status. However, taxpayers who are divorced under a final decree issued by the last day of the year are considered unmarried for the whole year and cannot choose married filing jointly or married filing separately as their filing status.

Board Position:

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<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Gerald Goldberg

4/6/1999

Generally, a joint return cannot be filed if either spouse is a nonresident alien at any time during the tax year. However, if at the end of the year one spouse is a nonresident alien or dual-status alien married to an U.S. citizen or resident, both spouses can elect to file a joint return. If a joint return is filed, both spouses are treated as U.S. citizens or residents for the entire tax year.

Once a joint return is filed, the taxpayers cannot amend the return to file separate returns for that year after the due date for filing the tax return has passed.

Married taxpayers may choose "**married filing separately**" as their filing status. Married taxpayers who file separate returns generally report only their own income, exemptions, credits and deductions. However, income of taxpayers living in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington or Wisconsin) may be considered either separate income or community income for income tax purposes. If considered community income, one-half of the income and associated deductions must be reported by each spouse on separate returns.

Generally, married taxpayers who file separately cannot take the credit for child and dependent care expenses, the earned income credit, credit for the elderly or the disabled or the credit for adoption expenses. In addition, for married taxpayers who file separately, interest from series EE U.S. savings bonds that are used for higher education expenses cannot be excluded from income; contributions to individual retirement arrangements (IRAs) may not be deductible; and more social security benefits may be included in income.

Taxpayers who file separate returns may amend the return and choose the joint return filing status anytime within three years from the due date for filing the separate returns.

Taxpayers may file as "**head of household**" if they are unmarried or considered unmarried on the last day of the year. In addition, they must have paid more than half the cost of keeping a home for themselves and a qualifying person for more than half the year.

A taxpayer is considered unmarried for head of household purposes if the spouse was a nonresident alien at any time during the year and the taxpayer did not choose to treat the nonresident spouse as a resident alien.

Taxpayers may be eligible to use "**qualifying widow(er) with dependent child**" filing status for two years following the year of death of their spouse if they meet the following requirements:

- The taxpayer was entitled to file a joint return with the spouse for the year of death (regardless of whether they filed a joint return).
- The taxpayer did not remarry before the end of the tax year for which the return is being filed.
- The taxpayer has a child, stepchild, adopted child, or foster child for whom an exemption can be claimed.
- The taxpayer paid more than half the cost of keeping a home that is the main home for the taxpayer and that child for the entire year.

Under California law, a taxpayer is generally required to use the same filing status for California that was used on the federal income tax return. If a married couple files a joint federal return and one of the spouses was a California resident for the entire taxable year and the other spouse was a nonresident for all or any portion of the year, a joint nonresident return (Form 540NR) is required to be filed.

There are two exceptions to this rule: A married couple who files a joint federal return may file either separate returns or a joint nonresident return in California if either spouse was (1) an active member of the military during the taxable year, or (2) a nonresident of California for the entire taxable year and had no income from a California source during that year. Taxpayers who meet these exceptions may figure their tax both jointly and separately to determine which filing status results in the lower amount of tax. However, after filing a joint California return, separate returns cannot be filed after the due date for filing the tax return for that year has passed.

Existing state law provides no specific authority to allow the FTB to correct the taxpayer's filing status when it is discovered that the taxpayer used the incorrect filing status for federal purposes (and thus for state purposes, too).

Current state law does not specify what filing status should be used on the California return when a return is not required for federal income tax purposes.

This bill would allow the FTB to revise the California return to reflect the proper filing status (making the filing status different from the status on the federal return) when the filing status used on the return is determined to be incorrect. **This bill** also would allow taxpayers who are not required to file a federal return to select any filing status for the California return that could have been claimed on the federal return had one been required and allow taxpayers who file a joint return for federal purposes and are allowed to file either married filing separate returns or a single joint return for California purposes to change their California filing status to married filing separately after the due date for filing the return has passed.

Policy Considerations

This bill would assist the state by allowing the FTB to revise the California return to reflect the proper filing status when it determines that the filing status used on the taxpayer's federal income tax return was incorrect.

This bill would reduce taxpayer frustration by eliminating the restriction from filing separate returns after a joint return was filed for taxpayers who are allowed to file differently than they did for federal purposes.

The current law prohibiting a filing status change from a joint return to separate returns after the due date of the original return may be viewed as harsh and unfair treatment when a review of the return determines that the tax liability would be reduced under the married filing separately filing status. This bill would provide military personnel and certain nonresidents more flexibility in changing their filing status to reduce their California tax liability. The following example illustrates this problem.

Taxpayer (domiciled in Arizona) resided in California all year and had separate property income of \$10,000. Spouse is in the military (domiciled in Arizona, stationed in Bosnia all year) and earned \$60,000 military income. The couple files a joint nonresident return and incorrectly excludes all of the military income, but includes separate property income of the taxpayer.

Upon audit, the return is corrected to include one-half of the military income in the denominator of the nonresident ratio that is multiplied against the tax on gross income from all sources. The nonresident return ratio is .25 ($\$10,000/\$40,000$) -- this is the resident spouse's income divided by the resident spouse's income plus one-half of the military income. (The resident spouse's half of the community property is excluded.) The ratio (.25) is multiplied by the amount of tax on \$34,716 (spouse income plus one-half of military income minus standard deduction of \$5,284) which for 1998 is \$659 (\$799 tax less \$140 personal exemption credits), resulting in a net tax of \$165.

If the couple could change their filing status to married filing separately, their tax liability would be \$27. The military spouse would have no filing requirement since none of his income is from California sources. The resident spouse would file a resident return, reporting the \$10,000 income. The resident spouse's half of the military income is not taxable due to Section 17140.5. Tax on the \$10,000 income less the standard deduction is \$97. The personal exemption is subtracted from the tax of \$97 leaving a net tax of \$27.

Implementation Considerations

Implementation of this bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this bill would be minor since the number of cases that would be impacted is insignificant.

BOARD POSITION

Support.

At its December 16, 1998, meeting, the Franchise Tax Board voted to sponsor this legislation.